

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446, 461, 481; 1.446-1, 1.461-1, 1.461-4, 1.461-5, 1.481-1)

Rev. Proc. 2008-25

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor method of accounting for taxpayers using an accrual method of accounting that incur Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax (“payroll tax”) liabilities for compensation (including bonuses and vacation pay), and also provides procedures for taxpayers to obtain the automatic consent of the Commissioner of Internal Revenue to change to the safe harbor method of accounting.

SECTION 2. BACKGROUND

.01 Section 461(a) of the Internal Revenue Code provides that the amount of any deduction or credit must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

.02 Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides that, under

an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability (the “all events test”). See *also* § 1.446-1(c)(1)(ii)(A).

.03 Section 1.461-4(g)(6) provides generally that, if a taxpayer is liable to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed it.

.04 Section 1.461-5(b)(1) provides a recurring item exception to the general rule of economic performance. Under the recurring item exception, a liability is treated as incurred for a taxable year if: (i) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (ii) economic performance occurs on or before the earlier of (a) the date that the taxpayer files a return (including extensions) for the taxable year, or (b) the 15th day of the 9th calendar month after the close of the taxable year; (iii) the liability is recurring in nature; and (iv) either the amount of the liability is not material or accrual of the liability in the taxable year results in better matching of the liability against the income to which it relates than would result from accrual of the liability in the taxable year in which economic performance occurs. Section 1.461-5(b)(5)(ii) provides that, in the case of a liability for taxes, the matching requirement of the recurring item exception is deemed satisfied.

.05 Section 3111 imposes a liability on employers for their share of FICA

taxes and § 3301 imposes a liability on employers for FUTA taxes. The employer's portion of FICA taxes consists of a component for old-age, survivors, and disability insurance (social security tax) and a component for hospital insurance tax (Medicare tax). The social security tax applies only to wages paid by an employer to an employee during a calendar year not exceeding the contribution and benefit base (as determined under section 230 of the Social Security Act), which is \$102,000 in 2008. Thus, there is a ceiling on the wages subject to social security tax. In contrast, there is no ceiling on wages subject to the Medicare tax. See §§ 3301, 3111, and 3121(a). FUTA taxes are imposed on the first \$7,000 of wages paid to a covered employee by an employer during the calendar year. See § 3301(2). Employers are allowed credits against the FUTA tax through participation in state unemployment compensation laws. See § 3301 et seq.

.06 For many years, Service position was that FICA and FUTA taxes for accrual method taxpayers were treated as incurred only in the taxable year the compensation giving rise to the payroll tax liability was paid. For example, Rev. Rul. 69-587, 1969-2 C.B. 108, concludes that, under the all events test of § 461, an accrual method employer generally may not deduct payroll taxes payable with respect to bonuses and vacation pay accrued but unpaid at year-end until the taxable year in which the bonuses and vacation pay are paid. Similarly, Rev. Rul. 74-70, 1974-1 C.B. 116, concludes that, under the all events test of § 461, an accrual method employer generally may not deduct its share of FICA taxes

payable with respect to wages accrued but unpaid at year-end until the taxable year in which those wages are actually or constructively paid.

The Service's position on the accrual of payroll taxes was challenged in litigation. The Court of Claims in *Eastman Kodak Co. v. United States*, 534 F.2d 252 (Ct. Cl. 1976), *acq.*, 1996-2 C.B. 1, addressed the deductibility of FICA and FUTA taxes on wages, bonuses, and vacation pay accrued in Year 1 but paid in Year 2. The court held, contrary to Rev. Rul. 74-70, that the fact of the liability for payroll taxes on the wages was established in Year 1 as an automatic consequence of the definite and legal obligation to pay the year-end wages. However, the court also held that the fact of the liability for payroll taxes on bonuses and vacation pay was not established in Year 1 because of the uncertainty as of the end of Year 1 that the employee may have reached the payroll tax ceiling at the time of payment in Year 2.

.07 Consistent with the court's holding in *Eastman Kodak*, the Service conceded the issue of deductibility of payroll taxes for year-end wages in Rev. Rul. 96-51, 1996-2 C.B. 36. Rev. Rul. 96-51, which revoked Rev. Rul. 74-70, concludes that, under the all events test of § 461, an accrual method employer may deduct in Year 1 its otherwise deductible payroll taxes imposed on year-end wages properly accrued in Year 1 but paid in Year 2, provided the employer satisfies the requirements of the recurring item exception in § 1.461-5 with respect to those taxes. In Rev. Rul. 96-51, the year-end wages were paid before the 15th day of the 3rd calendar month after the end of Year 1 and, thus, were not

deferred compensation under § 404. Because the year-end wages were not deferred compensation, Rev. Rul. 96-51 does not address the application of § 404 to payroll taxes on deferred compensation.

.08 Rev. Rul. 2007-12, 2007-11 I.R.B. 685, revoked Rev. Rul. 69-587 and amplified Rev. Rul. 96-51. Rev. Rul. 2007-12 concludes that if the all events test and recurring item exception of § 461 are otherwise met, an accrual method taxpayer may treat its payroll tax liability as incurred in Year 1, regardless of whether the compensation to which the liability relates is deferred compensation that is deductible under § 404 in Year 2.

.09 The Service and the Department of the Treasury recognize that the proper accrual of FICA and FUTA tax liabilities continues to be an area of uncertainty for taxpayers. As noted by the Court of Claims in *Eastman Kodak*, a taxpayer that has a fixed liability to pay the compensation to which the payroll taxes relate may not know, as of the end of the taxable year, whether a particular employee will have reached any applicable payroll tax ceiling by the time the tax ultimately is paid, raising a question as to when the payroll tax liability is fixed. In addition, the ceiling limitations no longer exist on the Medicare portion of an employer's payroll tax liability, and the ceiling limitations that still exist on other portions of an employer's payroll tax liability are significantly higher than those addressed in *Eastman Kodak*. Therefore, for reasons of administrative convenience and to reduce further controversy, the Service will not challenge a taxpayer's use of the safe harbor method of accounting described in section 4.01

of this revenue procedure for payroll taxes on compensation.

.10 Under § 446(b), the Commissioner has broad authority to determine whether a method of accounting clearly reflects income. Section 1.446-1(c)(2)(ii) provides that the Commissioner may authorize a taxpayer to adopt or change to a permissible method of accounting although the method is not specifically described in the regulations as permissible if, in the opinion of the Commissioner, that method clearly reflects income.

.11 Section 446(e) and § 1.446-1(e)(2)(i) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions necessary to obtain the Commissioner's consent to effect the change in method of accounting and to prevent amounts from being duplicated or omitted.

.12 Section 481(a) requires adjustments necessary to prevent amounts from being duplicated or omitted by reason of a change in method of accounting.

.13 Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432), provides procedures by which a taxpayer may obtain automatic consent to change to a method of accounting described in the Appendix of Rev. Proc. 2002-9.

SECTION 3. SCOPE

This revenue procedure applies to an accrual method taxpayer that uses the recurring item exception under § 1.461-5 for its payroll tax liabilities and chooses to account for its payroll tax liabilities using the safe harbor method of accounting described in section 4.01 of this revenue procedure. This revenue procedure does not apply to an employee's portion of FICA tax imposed under § 3101 and deducted by the employer from wages paid to the employee.

SECTION 4. SAFE HARBOR METHOD

.01 *In General.* Under the safe harbor method of accounting, and solely for purposes of the recurring item exception provided in § 1.461-5, a taxpayer will be treated as satisfying the requirement in § 1.461-5(b)(1)(i) for its payroll tax liability in the same taxable year in which all events have occurred that establish the fact of the related compensation liability and the amount of the related compensation liability can be determined with reasonable accuracy.

.02 *Examples.*

(1) *Example 1.* X uses an accrual method of accounting, including the use of the recurring item exception, and files its returns on a calendar year basis. X properly changes to the safe harbor method of accounting described in section 4.01 of this revenue procedure for its payroll tax liabilities. During Year 1, A, an employee of X, earns \$10,000 of vested vacation compensation for services performed during Year 1. X pays the vacation compensation to A in February and May of Year 2. X incurs a payroll tax liability for the \$10,000 vested vacation compensation payment. Assume

that, as of December 31 of Year 1, all events have occurred to establish the fact of X's vested vacation compensation liability and the amount of the liability is determinable with reasonable accuracy. Under the provisions of this revenue procedure, and solely for purposes of applying the recurring item exception, all events necessary to establish the fact of X's payroll tax liability for the \$10,000 vested vacation compensation will be treated as having occurred in Year 1 and the amount of the payroll tax liability will be treated as being determined with reasonable accuracy in Year 1.

(2) *Example 2.* Y uses an accrual method of accounting, including the use of the recurring item exception, and files its returns on a calendar year basis. X properly changes to the safe harbor method of accounting described in section 4.01 of this revenue procedure for its payroll tax liabilities. On December 28 of Year 1, Y's board of directors approves a bonus pool of \$1,000,000 to be paid to Y's employees for services provided during Year 1. The \$1,000,000 in bonuses is paid to Y's employees on January 5 of Year 2. Y incurs a payroll tax liability as a result of the \$1,000,000 in bonuses paid to its employees. Assume that, as of December 31 of Year 1, all events have occurred to establish the fact of the bonus compensation liability and the amount of the liability is determinable with reasonable accuracy. Under the provisions of this revenue procedure, and solely for purposes of applying the recurring item exception, all events necessary to establish the fact of Y's payroll tax liability for the \$1,000,000 in bonuses will be treated as having occurred in Year 1, and the amount of the payroll tax liability will be treated as being determined with reasonable accuracy in Year 1.

SECTION 5. CHANGE IN METHOD OF ACCOUNTING

.01 *In General.* A change in the treatment of payroll tax liabilities to conform to the safe harbor method provided by this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

.02 *Automatic change to the safe harbor method.* A taxpayer within the scope of this revenue procedure that wants to change its treatment of payroll tax liabilities to conform to the safe harbor method of accounting provided in this revenue procedure (including a change to use the recurring item exception for such payroll tax liabilities) must follow the automatic change in accounting method provisions of Rev. Proc. 2002-9, with the following modifications:

(i) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to make the change for its first taxable year ending on or after December 31, 2007.

(ii) For purposes of completing line 1a of Form 3115, *Application for Change in Accounting Method*, the designated automatic accounting method change number for the change in method of accounting provided in this revenue procedure is No. 113.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified and amplified to include this automatic change in section 10.02 of the APPENDIX.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after

December 31, 2007. The Service will not challenge a taxpayer's use of the safe harbor method of accounting described in this revenue procedure on a federal income tax return filed before March 11, 2008, if the taxpayer meets the requirements of this revenue procedure in that taxable year. Moreover, if the taxpayer's use of the safe harbor method on a federal income tax return filed before March 11, 2008, is an issue under consideration in examination, appeals, or before a federal court, the issue will not be further pursued by the Service.

DRAFTING INFORMATION

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